CHAPTER VI

FREE TRADE VERSUS PROTECTION

I. Introductory:-

In the case of free trade a nation does not impose any restrictions upon its international trade with the object of protecting its industries against foreign competition. In the case of protection, a country taxes imported foreign commodities which compete with domestic industries or it taxes export of raw materials which can be worked up into manufactures at home. The former taxes are known as Import Duties and the latter Export Duties.

Protective duties must be distinguished from Revenue Duties. Revenue Duties solely operate to bring in revenue and have no effect on the direction of industries.

Protectionists and Free Traders are equally interested in the well being and development of their country; but their methods differ. The protectionists believe in the necessity of intervention with the volume and composition of the external trade of a country. Thus only by protection can the country's ultimate interest be safeguarded. The free traders argue that a country's ultimate interests are best promoted by the state doing nothing. There should be no intervention and no devices of any kind.

II. Methods by which Protectionists would develop Home Industries:-

1) Import Duties:-

These impose a financial burden on competing foreign products so as to make their selling price higher than or at least equal to the selling price of the home product. The price of the home product tends to be high in the initial stages. The assumption underlying the levy of import duties is that the price is raised by the full amount of the duty. The amount of the duty should be at least equal to the difference between cost of production at home and cost of production in foreign countries.

2) Export Duties:-

These have for their object the preservation for home use the raw materials which are bought by foreign countries. The assumption is that the duty will reduce the profits of the producer if he were to sell abroad and therefore he will be compelled to turn to the home buyer.

3) Bounties or Subsidies:-

These are money contributions made by governments to help a particular industry. In fact they are additions given by governments to the price received by the producers from the consumers through the ordinary operations of the market. Bounties may be direct or indirect. Bounties

may be given directly either on the amount of the article produced in the country or on the amount exported from the country. Example of indirect bounties are provision of the services of experts, sale at specially low prices of raw materials produced under state monopoly, reduced freight rate on state railways, supply of capital by Government on cheap terms, etc.

4) Dumping:-

We have dumping whenever the producers of a commodity sell the surplus in foreign countries at excessively low prices. Thereby they seek to keep up prices in the domestic market which is their chief market.

5) Reciprocity:-

It assumes that restriction on foreign trade gives advantages to the nation that employs it but looses by the restrictions placed by its neighbours. A removal of these restrictions will be for the good of both but must be strictly reciprocal.

6) Retaliation:-

People who advocate retaliation believe in free trade but resort to retaliation or protective measures only to compel foreigners to reduce or ~~foreigners~~ give up their protective taxes.

3/3

7) Imperial Preference:-

It has for its object the encouragement of trade within the empire - the mother countries, colonies and dependencies. Trade within the Empire is fostered by the levy of higher duties upon the import of foreign products than upon Empire products.

III. Incidence of Protective Duties:-

We are concerned chiefly with the incidence of import duties. The question is, who ultimately pays these duties. There are four possibilities, namely,

(a) the whole of the duty is paid by the foreign producer;

(b) the whole of the duty is paid by the home consumer;

(c) the whole of the duty is divided between the foreigner and the home consumer; and

(d) the whole of the duty is paid by neither the foreign producer nor the home consumer, since it is possible for the foreign producer to sell at the same price as before by reducing his expenses of production.

Broadly speaking the tendency of import duties is to raise the prices of the article taxed. Taussig says, "When a duty is imposed on a commodity, its price usually rises

by the amount of the duty. The duty is added to the price and the consumer pays both". In consideration as to who pays the duty ultimately, we have to bear in mind whether the commodity is produced under conditions of monopoly or otherwise, whether it is produced under increasing or decreasing returns, whether the demand for the commodity is elastic and whether there is any second market for the commodity in another country.

IV. Arguments for Protection:-

Bastable classifies as many as twenty arguments for protection. He says, "Some of these arguments possess real importance and have had serious influence on public policy while others rest on exploded fallacy or merely appeal to vulgar prejudices.

The Infant Industry Argument:- The strongest economic argument in favour of protection is the Infant Industry Argument. The argument was first advanced in the United States in the early part of the nineteenth century and it was carried from the U.S.A. to Germany by Frederick List, its best known advocate.

The Infant Industry Argument takes a special form and a general form. In its special form it advocates temporary protection for selected industries which are specially suited to a country because of the existence there of an abundant supply of raw materials and because of the aptitudes of the

3/7

people. In its general form it states that countries have to pass through definite stages in the history of their industrial development and that protection is necessary to enable a country to pass from an agricultural stage to the manufacturing stage.

The theoretical validity of the argument has been admitted by almost all economists. Its truth was recognized by J.S. Mill, one of the staunchest advocates of Free Trade. Says he, "The only case in which on mere principles of political economy protective duties can be defensible is when they are imposed temporarily (especially in an young and rising nation) in hopes of nationalizing a foreign industry in itself perfectly suitable to the circumstances of the country. But the protection should be confined to cases in which there is good ground of assurance that the industry which it fosters will after a time be able to dispense with it".

Countries have developed their industrial resources at different rates. Thus it may happen that an industry, which is well established in one country finds difficulty in establishing itself in another because during the period of its infancy it has to fight for markets against the highly developed firms of other countries. If the home market could be reserved for it during this period of experiment, it might grow up sufficiently healthy and strong to stand

unprotected the severity of foreign competition.

There are, however, two difficulties:

(a) Developing industry creates vested interests. Capital is invested in the industry and the owners bitterly oppose any attempt to remove the tariff. In their estimation the industry remains always a tender infant. It never grows up. Even if actually it would be able to stand alone they are afraid to try it in case the breath of competition should kill it.

(b) One of the advantages of competition is that the producers are forced to advance, to experiment and to strive for better quality at a cheaper price in order to get a share of the market. Protection of an infant industry may have exactly the opposite effect. Having a virtual monopoly of the home market, firms are able to make a profit without using the period of protection in the way it was meant to be used, that is to say, to improve methods, materials and organization. The result is that the protected industry becomes slack and inefficient; and realizing its lack of preparation to meet foreign competition, it strenuously opposes the removal of the duty.

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